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STATE OF ILLINOIS

ILLINOIS COMMERCE COMMISSION

Illinois-American Water Company	)	
	)	
Proposed General Increase	)	Docket No. 02-0690
in Water and Sewer Rates.	)	

INITIAL BRIEF OF
ILLINOIS-AMERICAN WATER COMPANY

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(REDACTED)

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Illinois-American Water Company ("Illinois-American" or "Company"), by its attorneys, hereby presents its initial brief in support of its requested rate relief.

I.

EXECUTIVE SUMMARY

For America, September 11, 2001 is synonymous with December 7, 1941, sixty years earlier. No explanation is needed for the obvious.

"Homeland security has been one of the greatest challenges in American history and it is also proven to be one of the greatest American success stories. * * * Although drinking water in the United States has long been recognized as among the safest in the world, the devastating events of 9/11 brought water security to the forefront as a priority. Since then, the security of America's water supply has been one of the most critical components of the nation's homeland security efforts. Ultimately, the success of this massive, unprecedented effort will be judged by the terrorist attack we have been able to prevent." Jack Hoffbuhr, Executive Director, American Water Works Association (AWWA News Release, May 1, 2003.)

"A secure water supply is a cornerstone of homeland security. * * * We are now living in a world where every effort has to be made to protect and to dissuade and prevent acts of

terrorism from occurring. The American drinking water profession has built a tradition and reputation for delivering clean and safe drinking water, we are now making the same commitment to the security of the nation's drinking water supply." Lynn Stoval, President, American Water Works Association (AWWA News Release, May 1, 2003.)

The most important issue remaining to be resolved in this rate case is whether Illinois-American is entitled to recover the costs of enhanced security measures incurred from September 11, 2001 until the rate order is issued in this case. These costs are the Deferred Security Costs.

Staff expert security witness Jaehne has testified that the enhanced security measures, and the resulting Deferred Security Costs, are prudent. Staff has not challenged the fact that the Deferred Security Costs are prudent. Moreover, that Staff asked Mr. Jaehne to review the Deferred Security Costs for prudency is indicative that Staff believes these are recoverable costs.

Company witnesses Ruckman and Mitchem have testified that these enhanced security measures and resulting costs were necessary to enable the Company to continue to provide safe and adequate water to its customers in compliance with the Safe Drinking Water Act and applicable regulations and law.

Staff's accounting witness Sant has testified that, although these costs were necessary costs, the Company should not be able to recover these costs because they are "out of test year period" costs.

Staff witness Sant is attempting to shoehorn extraordinary, but prudent, security costs into narrow accounting concepts reserved for ordinary operating expenses such as chemicals and power. This is an example of what Cardozo called the tendency of a principle to extend beyond the limits of its logic.

This brief will demonstrate that there is substantial precedent, as well as common sense reasoning, which justifies full recovery of Deferred Security Costs.

From the Company's perspective, the remaining issues with Staff pertain to recovery of deferred reverse osmosis pilot study cost, interest rates on certain debt issues, certain incentive compensation costs, certain charitable donations, the allocation method for security costs, and certain rate design corrections.

All other issues have been resolved as between the Company and Staff. This brief also will address remaining issues raised by Intervenors.

The Company and the City of O'Fallon have entered into a letter of intent, which describes an arrangement under which the Company would provide a wholesale water supply under a long-term competitive alternative agreement designed to retain O'Fallon as a customer. This resolution of the dispute between the Company and the City is contingent upon the recognition of the arrangement in revenue requirements allowed in this case.

II.

INTRODUCTION

Illinois-American has filed revised schedules proposing a general rate increase for all service areas. This case includes the Chicago-Metro Division, acquired from Citizens Utilities Company of Illinois in January, 2002, which had not had a rate increase since 1995. It also includes the Pekin District and the Lincoln District, which have not had rate increases since 1997 and 1996, respectively.

The Company and Staff have reached agreement upon all issues except for the following:

- Deferred Security Costs
- Deferred Reverse Osmosis Costs

- Interest Rate on Certain Rate Debt
- Certain Charitable Donations
- Certain Incentive Compensation
- Method for Allocating Security Costs

Of particular importance, the Company has agreed to Staff's recommended cost of equity of 10.27%.

Several intervenors presented testimony, raising certain issues which also will be addressed in this brief. All of their proposals should be rejected.

The Company and intervenor City of O'Fallon entered into a letter of intent, under which the Company has proposed a competitive alternative rate for water delivered to the City. If this rate is reflected in revenue requirements and rate design determined in this case, matters will be resolved as between the Company and O'Fallon.

III.

THE COMMISSION SHOULD ALLOW RECOVERY OF ALL DEFERRED SECURITY COSTS

A. Description Of Deferred Security Costs

In immediate response to September 11, 2001 (9/11), Illinois-American implemented enhanced security measures. **(DELETED/PROPRIETARY INFORMATION.)**

The costs of these enhanced security measures, for the period 9/11 until the rate order is entered in this case, are the Deferred Security Costs. **(DELETED/PROPRIETARY INFORMATION.)**

The costs of enhanced security after the rate order is entered are Ongoing Security Costs. They are not at issue.

B. Description Of Staff Witness Jaehne's Position

Staff witness Jaehne is Staff's expert security witness. Mr. Jaehne concluded that the Deferred Security Costs are prudent. (Staff Ex. 10.0, pp. 14-15.) He also concluded that the Ongoing Security Costs are prudent, with certain adjustments, to which the Company has agreed. (Staff Ex. 10.0, pp. 15-18.)

C. Description Of Staff Witness Sant's Position

Staff does not dispute that the Deferred Security Costs are prudent and reasonable. (Staff Ex. 10, 20, Tr. 518.) In addition, Staff accounting witness Sant stated that he personally believes that they are "necessary costs." (Tr. 514.) He also stated that, in his personal opinion, it was in the public's interest to have provided enhanced security measures, the costs of which are included in Deferred Security Costs. (Tr. 515.) Also, Mr. Sant does not dispute Ongoing Security Costs.

Staff witness Sant's sole reason for proposing denial of recovery of Deferred Security Costs is his assertion that recovery would violate the concept of a test year. He cites two prior Commission orders, Docket No. 98-0895 and Docket No. 93-0408.

The order in Docket No. 98-0895 is not relevant because it did not involve a question of recovery in rates of a deferred cost. Moreover, the Commission indicated that the costs at issue there were not large or unique. It said, "Although the expenses appear to be reasonable and

made in the public interest, they are not sufficiently large, or sufficiently unique, to justify special accounting treatment." Illinois-American's Deferred Security Costs are both large and unique. They are $10,651,250 or 4.4% of total operating expenses during the deferral period. (Tr. 516.) Mr. Sant did not dispute that they are large. (Tr. 516.)

Mr. Sant also cited an order in Docket No. 93-0408, which was a proposed rulemaking proceeding initiated by some utilities seeking a rule on deferred costs. The Commission dismissed the proceeding, seeing no need for a rule. In so doing, the Commission cited the Illinois Supreme Court decision commonly known as "*BPI II*" (*Business and Professional People v. Ill. Com. Comm'n*, 146 Ill. 2d 175 (1991)). The Company will show below that *BPI II* does not support Mr. Sant's position.

D. Deferred Security Costs Are Recoverable Under *Citizens Utilities Board* As Environmental Compliance Costs

In its 1991 decision in *BPI II*, the Illinois Supreme Court held that Edison could not recover deferred depreciation expense and deferred decommissioning costs. It stated that recovery of these deferred expenses would violate test-year principles. However, the Court held that deferred financing charges did not violate test-year principles.

In 1995, the Illinois Supreme Court allowed recovery of deferred environmental compliance costs. *Citizens Utilities Board v. ICC*, 166 Ill. 2d 111 (1995). That case concerned clean-up of former manufactured gas sites contaminated by coal-tar.

The Commission proceeding in *Citizens Utilities Board* was a generic rulemaking case which followed three company-specific cases in which the Commission allowed deferred cost recovery of coal-tar clean-up costs. In one of the prior cases, *Central Illinois Light Company*, Docket No. 90-0127, on rehearing, the Commission noted that no order had been issued by either IEPA or U.S. EPA to clean-up a site – all actions by CILCO were voluntary. The Commission

concluded that the actions were "reasonable and necessary," and that "CILCO has exercised good business judgment with respect to the actions taken to identify, investigate and remediate coal tar sites. Remediation is necessary to avoid the possibility of future hazards, and failure to remediate voluntarily could result in the issuance of an IEPA 4(q) notice, loss of control over the remediation activities, and higher costs." The Commission concluded that:

- "as a matter of public policy we believe that it is appropriate to allow the recovery of the costs of environmental controls."

- "the Public Utilities Act emphasizes the importance of allowing for the recovery of environmental costs as being within the public policy of the state."

The Supreme Court held that utilities are entitled to recover deferred coal-tar clean up costs over a five year amortization period, with carrying charges on the unamortized balance.

The Court stated that the Commission "must allow the utility to recover costs prudently and reasonably incurred." *Id.* at 121. It also stated that "coal-tar cleanup expenses benefit a utility's ratepayers because payment of this legally mandated cost allows a utility to remain in business and to continue to provide service to its customers." *Id.* at 123.

As Company witness Ruckman testified herein, Deferred Security Costs are deferred environmental compliance costs similar to those allowed to be recovered by the Commission and the Supreme Court in the *Citizens Utilities Board* case. (Ex. R-1.0, p. 4.) "They are costs incurred to prevent the interruption and contamination of the potable water supply the Company distributes to its customers and contamination from the wastewater collected by the Company. They are reasonable and necessary. These costs are compliance costs incurred to satisfy the requirements of the law." (*Id.*)

Indeed, on March 12, 2003, Attorney General Ashcroft stated security for water supplies is an environmental issue. Attached as Appendix A to this brief is a copy of the Associated Press

story of Mr. Ashcroft's statement. It states, in part, "Emphasizing homeland security as an environmental issue, Ashcroft pledged to increase the Justice Department's prosecution of civil cases to make operators of ... drinking water facilities comply with environmental and safety laws" and "to ensure that ... water supplies are protected."

The environmental compliance requirements include the following:

- Section 8-101 of the Public Utilities Act requires that "every public utility shall furnish, provide and maintain such service instrumentalities, equipment and facilities as shall promote the safety, health, comfort and convenience of its patrons, employees and public and as shall be in all respects adequate, efficient, just and reasonable."

- Section 8-401 of the Public Utilities Act states that "every public utility subject to this Act shall provide service and facilities which are in all respects adequate, efficient, reliable and environmentally safe ..."

- The Commission has prescribed standards of service for water utilities, 83 Ill. Adm. Code Part 600. Section 600.210 states that "each utility shall furnish a safe water supply suitable for drinking and free of any hazard to health in adequate quantities to meet the needs of its customers. The water should be free from objectionable odor and taste and should be colorless. It shall conform to the standards for drinking water as established by the State of Illinois, Environmental Protection Agency or any successor agency or organization."

- Section 600.220 states that "each utility shall make all reasonable efforts to prevent interruptions of service."

- Section 600.230 states that "each utility shall furnish and maintain sufficient facilities to provide a continuous and adequate supply of water at reasonable pressure."

- The federal Safe Drinking Water Act, 42 U.S.C. 300f, *et seq.*, and the regulations of the U.S. EPA under the Act, 40 C.F.R. Parts 141-143, establish maximum contaminant levels for numerous constituents of water provided by the Company, as well as other requirements applicable to the quality of water.

- The Illinois Environmental Protection Act, 415 ILCS 5/1, *et seq.*, and the regulations of the Illinois Environmental Protection Agency and the Illinois Pollution Control Board under the Act, also establish requirements for the quality of water distributed by the Company.

The enhanced security measures put into place by the Company after 9/11 are intended to facilitate the Company's compliance with these environmental legal requirements, in the face of the unprecedented threats of contamination and interruption of water service due to terrorism. (Ex. R-1.0, p. 5.) The enhanced security measures are recommended by the United States Environmental Protection Agency (U.S. EPA), Illinois Environmental Protection Agency (IEPA), the National Association of Regulatory Utility Commissioners (NARUC) and others to protect water utilities' ability to provide safe and continuous water in compliance with the environmental requirements of the law.

In October 2001, the USEPA issued an advisory recognizing "One consequence of the events of September 11th is a heightened concern among citizens in the United States over the security of their drinking water supply." The advisory contains numerous recommendations as to what drinking water utilities can do "now" (i.e., as of October 2001) to guard against terrorist and security threats. The recommendations include methods to guard against unplanned physical intrusion, including posting guards at treatment plants, making security a priority for employees,

coordinating actions for effective emergency response and investing in security and infrastructure improvement. (A copy of the USEPA advisory is IAWC Exhibit R-1.1.) The Company has implemented these security measures.

Also in October, 2001, Illinois EPA issued a security advisory recommending implementation of stated security enhancements. (A copy of the advisory is IAWC Exhibit R–1.2.)

The November 14, 2001 Resolution of NARUC states that "water utilities are encouraged to take all necessary and prudent precautionary steps to secure facilities." (A copy of the NARUC Resolution is IAWC Exhibit R-1.3.)

Similarly, in January 2002, the National Infrastructure Protection Center issued an alert indicating that, "U.S. law enforcement and intelligence agencies have received indications that Al-Qa'ida members have sought information on Supervisory Control and Data Acquisition (SCADA) systems available on multiple SCADA-related Web sites. They specifically sought information on water supply and wastewater management practices in the US and abroad." *Terrorist Interest in Water Supply and SCADA Systems*, National Infrastructure Protection Center (NIPC) Information Bulletin 02-001 (January 27, 2002).

In light of the events of September 11, 2001, the Council on Foreign Relations established an Independent Task Force consisting of a number of distinguished Americans and co-chaired by former Senators Hart and Rudman, to review America's preparedness to deal with terrorist threats. In October 2002, the Task Force issued a report entitled *America Still Unprepared-America Still in Danger*, (the Hart-Rudman report), indicating that, "the system that provides Americans with a basic element of life – water – remains vulnerable to mass disruption ... America's water supply is extremely vulnerable to contamination." *Id.* at p. 27.

It has been reported that al Qaeda members have been investigating ways to contaminate or disrupt water supplies in the United States on a large scale, through contamination or

explosives. (*Water Tech Online*, July 16, 2002.) Osama Bin Laden is quoted as saying: "We must hit the U.S. economy with every available means. We must concentrate on the destruction of the American economy." (American Water Works Association *Urgent Security Advisory*, "Message from the Office of Homeland Security," October 10, 2002). "The Office of Homeland Security has recommended that all sectors remain vigilant in light of the al Qaeda threats to the U.S. economy" *Id.* "[T]he FBI urges recipients to review and implement additional prudent steps to detect, disrupt, deter and defend against potential attacks against our nation's critical infrastructure and installations at home and abroad." (American Water Works Association *Urgent Security Advisory*, "National Infrastructure Protection Center, Potential al Qaeda Threats to Targets in the United States and Abroad, Infrastructure Sector Notification," October 10, 2002.)

"Sabotage of water and wastewater systems has not historically been considered an immediate viable threat. Because of recent events, however, sabotage must now be considered not only as a viable threat but also as a plausible one." (Security, *Journal AWWA*, July, 2002.)

"The possibility of an attack on a water-related utility is no longer remote." Landers, *Safeguarding Water Utilities*, Civil Engineering Magazine (June, 2002) at pp. 48, 49. "The ultimate goal of terrorists extends beyond merely disrupting the quality or quantity of a community's drinking water or its ability to dispose of wastewater in an environmentally acceptable manner. They know that causing the public to lose confidence in the integrity and safety of its water infrastructure, particularly the drinking water delivered directly to homes and businesses, would have enormous ramifications." *Id.*

An item seized from a suspected terrorist cell in Seattle was "instructions on poisoning water sources." McDonnell and Meyer, *Evidence of Terror Cell Investigated in Seattle Links to al Qaeda and a 'Jihad Training Camp,'* The San Francisco Chronicle (July 13, 2002) p. A1.

"The nation's water utilities are preparing to defend themselves against possible terrorist attacks on pumping stations and pipes that serve its cities and suburbs. The effort, water officials

tell TIME, comes after the discovery of documents in Afghanistan that indicate al-Qaeda terrorists have been investigating ways to disrupt the U.S. water supply on a massive scale." Shannon, *A New Target: The Water Pipes*, Time Magazine (July 22, 2002).

Congress recognized the potential vulnerability of water systems when it enacted the Bioterrorism Act in June, 2002. (P.L. 107-188.) The Act requires each public water supply serving more than 3,300 persons to "conduct an assessment of the vulnerability of its system to a terrorist attack or other intentional acts intended to substantially disrupt the ability of the system to provide a safe and reliable supply of drinking water." (Sec. 401, P.L. 107-188.) In addition, water utilities must file emergency response plans which are to include actions, procedures and equipment to obviate or lessen the impact of such attacks or acts – *i.e.*, security measures. (A copy of the Bioterrorism Act is IAWC Exhibit R–1.4.)

The American Water Works Association has stated: "Because of recent events, however, sabotage must now be considered not only as a viable threat but also as a plausible one. It is important for cities, counties, provinces and private companies that own/or operate water and wastewater systems to consider what weaknesses may exist, determine what measures should be taken to prevent future acts of sabotage, vandalism, or terrorism; and develop a well-tested emergency response plan (ERP)." (An excerpt of AWWA's statement is IAWC Exhibit R–1.5.)

E. The Deferred Security Costs Are Prudent And Reasonable

Staff's expert security witness Jaehne testified that the Deferred Security Costs are prudent and reasonable. (Staff Ex. 10 and 20.) Staff does not disagree with inclusion in revenue requirements of Ongoing Security Costs to be incurred after the rate order is entered in this proceeding.

F. The Deferred Security Costs Are Recoverable Because They Are Prudent Costs of Service

In *Citizens Utilities Board*, the Illinois Supreme Court held that the Commission must allow recovery of costs prudently and reasonably incurred.

Along the same lines, in *United Cities Gas Co. v. ICC*, 225 Ill. App. 3d 771 (4th Dist. 1992), also subsequent to the *BPI II*, the Court held that a utility was entitled to recover as a deferred cost a consulting and non-compete agreement, amortized over the ten year life of the agreement. The Court said that, because the cost of the agreement was a legitimately incurred cost of service, the utility was entitled to recover it in rates. *Id.* at 778.

G. Staff Witness Sant's Extreme Position Is Contradicted By Precedent And Common Sense

If Mr. Sant's assertion that recovery of Deferred Security Cost is precluded by test-year principles were correct, no deferred costs ever would be recoverable because, by definition, all deferred costs are incurred outside of a test year.

However, Mr. Sant's assertion is contradicted by his own recommendation in this proceeding that the Company recover steel structure painting expense as a deferred cost and rate case expense as a deferred cost. He could not explain his inconsistency.

Mr. Sant's position also is contradicted by his acknowledgment, on cross-examination, that a recoverable deferred debit is anything in Account 186, including operating expense, which the Commission has accepted as recoverable. (Tr. 523-24.) He also acknowledged that Account 186 includes "extraordinary expenses," and that he has recommended that steel structure painting expense be recovered as a deferred cost. (Tr. 524.)

Further, Mr. Sant's assertion is contradicted by the court decisions in *Citizens Utilities Board* and *United Cities Gas*, discussed above.

In point of fact, the Commission never has adopted Mr. Sant's extreme view of non-recovery of deferred costs. In his rebuttal testimony, Mr. Ruckman gave the following examples where the Commission has approved rate recovery of deferred costs in other proceedings:

Illinois-American Water Company

Docket No. 95-0076: deferred maintenance

Docket No. 97-0081/97-0102: deferred maintenance

Docket No. 00-0340: deferred maintenance

Northern Illinois Water Company

Docket No. 89-0176: deferred franchise cost

Docket No. 93-0184: deferred extraordinary property loss

Docket No. 95-0220: deferred extraordinary property loss; deferred nitrate study costs

Docket No. 97-0254: deferred maintenance

Consumers Illinois Water Company

Docket No. 98-0632: deferred legal cost incurred to defend water quality claims against the utility

Central Illinois Public Service Company

Docket No. 90-0072: deferred management audit costs

Docket No. 91-0193: deferred management audit costs

Interstate Power Company

Docket No. 83-0256: deferred repair cost of gas line washed out by flood

GTE North Incorporated

Docket No. 93-0301 and 94-0041 Cons.: deferred flood damage repair cost

Illinois Bell Telephone Company

Docket No. 92-0448 and 93-0239 Cons.: deferred workforce resizing expenses

Commonwealth Edison Company

Docket No. 94-0065: deferred information systems consulting costs

H. Deferred Security Costs Meet The Tests For Recovery

Review of the Court decisions and Commission orders which allow recovery of deferred costs shows that allowable deferred costs have the following characteristics in common:

- The deferred costs at issue have not been included in revenue requirements used by the Commission to determine current rates.
- The deferred costs are prudent costs incurred in providing service to customers.
- The deferred costs are incurred to comply with a legal, environmental or regulatory requirement or to address an unanticipated event.

Illinois-American's Deferred Security Costs have all of these characteristics:

- They were not included in the revenue requirements used by the Commission in the Company's prior rate case to set current rates. Moreover, the Company has not earned its allowed rate of return since the rates were set.
- They are prudent costs, as confirmed by Staff expert security witness Jaehne, incurred to provide service to customers.

- They are incurred both to comply with legal and regulatory environmental and service requirements, and also to respond to the unanticipated event of 9/11 and subsequent terrorism threats.

Indeed, recovery of the Deferred Security Costs is even more compelling than recovery of many of the other types of deferred costs allowed to be recovered by the Commission, such as deferred maintenance, deferred litigation cost, deferred management costs, and deferred consulting costs. The Deferred Security Costs were necessary to assure the provision of safe drinking water, and the adequate supply for fire fighting and business use.

I. NARUC'S Resolution Supports Recovery Of Deferred Security Costs

NARUC has recognized the necessity for recovery of the costs of enhanced security measures incurred after 9/11. On March 13, 2002, NARUC adopted a Resolution which states, in part, that state commissions are encouraged "to identify and/or establish procedures for timely recovery of prudently increased security related costs." (A copy of the Resolution is IAWC Exhibit R–1.6.)

J. Illinois-American Did Not Have Any Alternative For Recovery Of Enhanced Security Costs Other Than This Rate Case

Prior to 9/11, it was impossible to know that such an extraordinary event would occur and would impose unimaginable terrorism risks on water utilities. The full burden of these risks and the costs of enhanced security measures after 9/11 was not immediately known and could not be immediately known. Even Mr. Sant admitted that 9/11 was a unique event, which he had not expected. (Tr. 516.)

The Company explored with Staff and others possible cost recovery approaches. However, the Company determined that the only available alternative was to file a general rate case. It obviously takes a great deal of time and effort to prepare a rate filing. This proceeding was initiated at the earliest practicable opportunity. (IAWC Ex. R-1.0, p. 11; IAWC Ex. SR-1.0, p. 6.)

Mr. Sant acknowledged that he is not aware of a recovery mechanism for security or for any other expense that may have dramatically, unexpectedly increased starting 9/11 or since the prior rate case. (Tr. 519.) Mr. Sant could not explain how, under his view, the Company can recover the costs of enhanced security during the pendency of this rate case. (Tr. 519.) He also stated that, if his position is accepted, the Company could not recover such costs in base rates. (Tr. 520.)

K. Denial Of Recovery Of Deferred Security Costs Would Be Confiscatory

As the Illinois Supreme Court stated in *Citizens Utilities Board*, the Commission must allow recovery in rates of prudently incurred costs of service. If recovery of Deferred Security Costs is not allowed, the Company will be denied recovery of a prudently incurred cost of service which benefited customers. That result would be confiscatory.

L. Staff Intends That The Company Recover Deferred Security Costs

Staff asked its expert security witness Jaehne to review the Deferred Security Costs and to determine whether they are reasonable and prudent. Mr. Jaehne did a comprehensive review of enhanced security measures beginning 9/11 to the test year, and in the test year. (Staff Ex. 10.0.)

Mr. Jaehne concluded that the actions taken upon 9/11, and the resulting costs included in Deferred Security Costs, are prudent. (*Id.*)

In his rebuttal testimony, Mr. Jaehne specifically addressed and defended the prudency of Deferred Security Costs against criticism by all witnesses for Intervenors. (Staff Ex. 20.)

Obviously, the facts that Staff asked Mr. Jaehne to review the prudency of Deferred Security Costs, and that Mr. Jaehne concluded that they are prudent, demonstrate that Staff intends that these costs are recoverable.

M. As A Matter Of Public Policy, Recovery Should Be Allowed

The *Citizens Utilities Board* decision of the Supreme Court, the provisions of the Public Utilities Act and regulations of the Commission, and the other authority discussed in Section III D above demonstrate an explicit, well-defined and dominant public policy requiring delivery of safe and adequate water.

Staff's proposed disallowance of recovery of Deferred Security Costs runs contrary to this public policy. It would discourage public utilities from responding immediately and appropriately to the emergency conditions brought by the risks of terrorist intrusion.

In the high risk environment beginning 9/11, the overriding public interest in having enhanced security measures protecting the public water supply clearly outbalances narrow accounting interpretations which are applicable more appropriately to ordinary operating expenses and which arose in the pre-9/11 era.

N. Contrary To Mr. Sant's Assertion, The Company Will Not Recover The Same Security Costs Twice

Mr. Sant erroneously asserted that, if the Company were allowed to recover Deferred Security Costs, it would recover the same costs twice. (Staff Ex. 4.0, pp. 5-6.) However, on cross-examination, he agreed that the same costs are not being recovered twice. (Tr. 523.)

As Mr. Ruckman pointed out, "the same costs are not being recovered twice. The Deferred Security Costs are the costs incurred from 9/11 through August, 2003. The current costs included in the test year are costs incurred beginning September 1, 2003, which is the approximate date on which the new rates will become effective." (IAWC Ex. R-1.0, p. 11.)

It is the nature of deferred costs that amortization can overlap current costs. For example, in Northern Illinois Water Corporation, Docket No. 93-0184, the Commission allowed deferred recovery of the damage to a water treatment facility addition. Construction was almost completed when a flood destroyed most of the work. The amortized amount of the property loss was included in the test year along with depreciation expense and rate base treatment of the cost of the reconstructed facility addition.

Another example is rate case expense. Staff has agreed to include in the test year unamortized rate case expense from the Company's prior rate case as well as rate case expense for the current proceeding.

Another example is Mr. Sant's own recommended treatment of steel structure painting cost as a deferred cost. The cost of painting to be incurred in the 2003 test year will be amortized over 15 years. Suppose the Company files a rate case in 2005 with a 2006 test year. That test year will include deferred cost recovery for painting in 2003, 2004 and 2005, as well as the 2006 test year. That is the nature of deferred costs. Certainly, Mr. Sant has not asserted that the Company would be recovering painting costs twice. Under Mr. Sant's extreme view, deferred costs never could be recovered, a result which would be confiscatory.

O. Contrary To Mr. Sant's Assertion, An Accounting Variance Is Not Necessary

According to the Commission's Uniform System of Accounts for Water Utilities, Account 186, the phrase "deferred by authorization of the Commission" relates only to "losses

on disposition of property net of income taxes." The separate category of "unusual or extraordinary expenses" is not qualified by the authorization phrase.

Ironically, Staff proposes to allow recovery of deferred rate case expense and deferred steel structure painting expense in this proceeding without the necessity for any prior deferral authorization.

In *Northern Illinois Water Corporation*, Docket No. 95-0220, the company had recorded in Account 183 deferred costs for its Vermilion River Watershed Study, Ion Exchange Pilot Plant Study and Groundwater Investigation. Staff testified that the deferred costs should be recorded in Account 186 and should be allowed to be recovered in rates. The Commission adopted Staff's proposal. There was no prior authorization of the deferral.

Certainly, in the instant proceeding, as in these other examples, the Commission can approve deferral treatment and recovery in rates of the deferred cost. Mr. Sant did not deny this fact.

P. Other State Commissions Have Allowed Recovery Of Deferred Security Costs

In an order entered December 13, 2002, the Florida Public Service Commission allowed recovery, in Florida Power & Light's fuel adjustment clause, of incremental 2002 and 2003 security costs. It stated, in part, "we stated that approving recovery of these incremental power plant security costs through the fuel clause would send an appropriate message to Florida's investor-owned electric utilities to encourage them to protect their generation assets in the extraordinary, emergency conditions that existed at the time. * * * Because these costs are extraordinary, these costs shall be treated as current year expenses." *In re: Fuel and Purchased Power Cost Recovery Clause and Generating Performance Incentive Factor*, 2002 Fla. PUC Lexis 1120.

Q. The Commission Should Reject Positions Of Intervenor Witnesses On Security

Intervenor City of O'Fallon presented testimony of its witness Brooks regarding enhanced security guard services and enhanced security water monitoring. Mr. Brook's testimony should be disregarded because the Company and O'Fallon have resolved their issues in a proposed water supply agreement as described in their letter of intent. (*See* Section IX of this Brief.) Further, both Company witness Mitchem (IAWC Ex. R-2.0, pp. 1-5) and Staff witness Jaehne (Staff Ex. 10.0 and 20.0) demonstrate that Mr. Brooks' assertions are unfounded.

Intervenor Citizens Utilities Board (CUB) presented its witness Morgan who initially proposed that security costs were unsupported because he asserted that the Company did not provide him with enough information. In his rebuttal testimony, p. 7, Mr. Morgan withdrew his objection and stated that the Company's security costs are reasonable.

(DELETED/PROPRIETARY INFORMATION.)

Accordingly, the assertions made by the Cities of Lincoln and Streator are without merit and should be rejected.

R. Conclusion: The Commission Should Allow Recovery Of Deferred Security Costs

As Staff expert security witness Jaehne has testified, the Deferred Security Costs are prudent and reasonable. Even Mr. Sant acknowledges that they are "necessary costs." They clearly are the type of deferred costs which the Illinois Supreme Court held were recoverable, in its 1995 *Citizens Utilities Board* decision, discussed above. They are costs incurred to help assure the Company's ability to continue to comply with the environmental and operational laws and regulations of the Public Utilities Act, the Commission, the Safe Drinking Water Act, U.S. EPA, the Illinois Environmental Protection Act, and IEPA.

As Mr. Ruckman stated, "these enhanced security costs were prudently incurred to safeguard our customers' drinking water supply and to protect against potentially catastrophic contamination. These are prudently and reasonably incurred costs of environmental controls and compliance and were necessary to enable the Company to satisfy its legally mandated obligations to continue to provide safe water service to its customers in the face of dramatically increased security risks." (IAWC Ex. R-1.0, p. 13.)

The Deferred Security Costs are recoverable under all legal precedent. Furthermore, as Sec. 1-102 of the Public Utilities Act states, one of the goals and objectives of Commission regulation is to ensure that "the prudently and reasonably incurred costs of environmental controls are recovered."

Finally, even the March 12, 2002 NARUC resolution calls for recovery.

If the Commission were to adopt Mr. Sant's proposed disallowance of Deferred Security Costs, it would give a very negative signal to utilities. It would tell them that "they should not immediately respond to terrorist threats to facilities and services or to other unanticipated situations, unless and until there is assurance of rate recovery. That, obviously, would be the wrong signal to send." (Ruckman, Ex. SR-1.0, p. 7.)

Staff's proposed adjustment raises a serious public policy issue. It would create a strong disincentive for utilities to promptly respond to unanticipated or unique situations such as terrorism which threaten reliable and safe utility service. That would be the wrong regulatory signal to send.

Staff has confirmed that the Company's enhanced security measures in response to the terrorist threats following 9/11 were and are prudent. These costs benefited the Company's customers. It is in the public interest that these costs, incurred to protect public health and to assure that the water supply remains safe, be recovered.

The Commission's rate order in *North Shore Gas Company*, Docket No. 95-0031, is instructive. The utility's Demand Side Management (DSM) activities had ceased. It deferred prior DSM costs because they were not in an amount sufficient to trigger recovery under its Rider 18. In the rate case, the utility proposed to cancel Rider 18 and recover the deferred DSM costs over a 3 year amortization period.

The Commission allowed recovery of deferred DSM costs, stating that it would be unfair to require the utility to write-off these deferred expenses. It also stated that "without any further activities, the costs that Respondent has deferred are left in limbo. Respondent correctly states that this Commission intended for these prudently incurred costs to be fully recoverable." (*Id.* at 28-29.)

Given the environmental and service requirements of the Public Utilities Act and the Commission's regulations, the Commission clearly intends that prudently incurred costs for enhanced security measures to be fully recoverable. Indeed, Staff asked its expert security witness to review and determine whether the Deferred Security Costs are prudent, for that very reason. And, he found them to be prudent.

Finally, the Commission should consider the implications of this scenario:

Suppose the Company had not implemented enhanced security measures at one of its water facilities after 9/11. Suppose further that a terrorist destroyed the facility with a bomb.

- The costs to the Company to replace the facility will be included in rate base.
- The original cost of the destroyed facility, net of accumulated depreciation, also will be recoverable in rates as a deferred cost amortized over a period of years.

This, of course, was the analogous result in *Northern Illinois Water Corporation*, Docket No. 93–0184, discussed above.

However, under Mr. Sant's proposal, the Company would not be allowed to recover the deferred costs of enhanced security costs to prevent destruction of the facility by a terrorist with a bomb. Mr. Sant's proposal makes no sense.

Under all precedent, sound policy and common sense, the Deferred Security Costs are recoverable.

IV.

THE COMMISSION SHOULD ALLOW RECOVERY OF DEFERRED REVERSE OSMOSIS PILOT STUDY COSTS

Staff witness Everson proposes that Deferred Reverse Osmosis Pilot Study Costs be disallowed. The Commission should reject her proposal.

A. Description Of Deferred Osmosis Pilot Study Deferred Cost

This item is the cost of a full scale pilot study of reverse osmosis technology for removal of nitrate contamination in the source water. The study was performed in 2001, at a cost of

$497,604. (Staff Ex. 12.0, Att. A.) The Company has treated this item as a deferred cost to be amortized in rates over a 5 year period.

B. History Of Nitrate Problem In The Streator District

Company witness Johnson has provided a history of the nitrate problem in Streator as follows:

"The source of water supply for the Streator Water Treatment Facility is the Vermilion River ("River"). As I explained in my direct testimony, the River has a long history of high nitrate levels related to agricultural fertilizer run-off. The United States Environmental Protection Agency ("USEPA") has imposed a Maximum Contaminant Level (MCL) of 10 mg/l for finished water nitrate. All water utilities must comply with this water quality standard.

"Northern Illinois Water Corporation ("NIWC"), the predecessor of Illinois-American in Streator, had been complying with the nitrate standard by storing low nitrate River water in a side-channel reservoir and blending that water with River water during high nitrate periods.

"However, nitrate levels in the River began to increase. NIWC was compelled to enter into a Letter of Commitment with the Illinois Environmental Protection Agency ("IEPA") to assure compliance with the nitrate standard by April, 1995.

"Thereupon, NIWC initiated an analysis of possible nitrate control alternatives, including:

- ion exchange treatment
- reverse osmosis treatment
- electrodialysis treatment
- alternative groundwater supply-Ticona aquifer

- side-channel reservoir expansion
- watershed management-nitrate control at the source

"The cost estimates for these alternatives ranged from $262,000 to $9.8 million.

"NIWC determined that the most cost-effective step was to try to solve the problem at the source through a watershed management program. NIWC initiated the Vermilion Watershed Task Force in 1993. This watershed group actively promotes best nitrogen management practices and other nitrate control measures.

"The watershed program proved successful until 2001, when nitrate levels in the River once again soared and low-nitrate water in the side-channel reservoir was depleted and not available for blending. The Company concluded that nitrate removal treatment was necessary as it became clear that voluntary efforts to control nitrate at the source could not be assured.

"The selection of an appropriate water treatment technology is complex and frequently centers around the waste produced in the treatment process. Pilot testing of new treatment processes is critical to determine the viability of the process and the quantity and type of waste produced. In fact, IEPA **requires** pilot testing of new treatment processes to ensure viability. In 1993, NIWC pilot tested only ion exchange treatment as it appeared to be the most economical at the time. In 2001, the Company rented and installed temporary reverse osmosis treatment equipment as a further pilot study of nitrate removal technology. As I stated in my direct testimony, the Company wanted to make sure that all viable treatment techniques were examined in the field prior to installation of permanent facilities. The data gathered from both pilot studies was invaluable in determining treatment viability, waste characteristics and cost. Clearly, the cost of the study was an investigative cost properly recorded as a deferred cost. Ultimately, the Company selected ion exchange treatment, which was installed in 2002, as I previously testified." (IAWC Ex. R-3.0, pp. 5-7).

In 2002, the Company installed permanent ion exchange technology at Streator for removal of nitrates, having determined that it was the most cost-effective removal technology.

C. Staff's Position

Staff does not dispute that the Deferred Reverse Osmosis Pilot Study Costs are prudent and reasonable costs of service. Instead, Staff witness Everson asserts that recovery of this deferred cost would violate the concept of a test year. Therefore, she makes an assertion similar to that of Mr. Sant regarding Deferred Security Costs, and she also relies on the Commission's order in Docket No. 98-0895.

D. Deferred Reverse Osmosis Pilot Study Costs Are Recoverable For The Same Reasons Deferred Security Costs Are Recoverable

For all the reasons discussed above regarding Deferred Security Costs (pp. 6-23), Deferred Reverse Osmosis Pilot Study Costs also are recoverable.

In particular, Ms. Everson's reliance upon the order in Docket No. 98-0895 is misplaced because that case did not involve a question of rate recovery of a deferred cost.

The Company's Deferred Reverse Osmosis Pilot Study Cost falls squarely within *Citizens Utilities Board v. ICC*, 166 Ill. 2d 111 (1995), which allowed recovery of deferred environmental compliance costs. The Court stated that utilities are entitled to recover deferred coal-tar clean up costs over a five year amortization period, with carrying charges on the unamortized balance.

The Court stated that the Commission "must allow the utility to recover costs prudently and reasonably incurred." *Id.* at 121. It also stated that "coal-tar cleanup expenses benefit a utility's ratepayers because payment of this legally mandated cost allows a utility to remain in business and to continue to provide service to its customers." *Id.* at 123.

The Deferred Reverse Osmosis Pilot Study Costs are costs incurred to enable the Company to continue to assure that its customers will not be exposed to harmful levels of nitrate and to maintain compliance with U.S. EPA's limit for nitrate, 10 mg/l, by choosing the most cost-effective nitrate removal technology.

As Mr. Johnson explained, Ex. SR-3.0, pp. 2-3, these deferred costs "are costs to perform a full scale pilot study of the reverse osmosis technology for removal of nitrates from the water supply. * * * Reverse Osmosis treatment technology was one of six (6) nitrate control alternatives considered. Also, * * * waste issues dictate water treatment solutions. Before implementing a final treatment alternative, it was paramount that treatment viability and waste quantities/characteristics of multiple treatment options be tested and analyzed. In addition, the Illinois EPA will not permit installation of a Reverse Osmosis treatment without a pilot study. Northern Illinois Water Corporation (NIWC), which subsequently merged into Illinois-American, had performed a pilot study of ion exchange technology in 1993, but neither it nor Illinois-American had previously tested Reverse Osmosis."

E. Deferred Reverse Osmosis Pilot Study Costs Are Recoverable Under Prior Identical Precedent

Prior to its merger with Illinois-American in 1999, NIWC provided water service in Streator, as mentioned above. In its rate case, Docket No. 95-0220, Staff witness Gorniak proposed that the costs of NIWC's Ion Exchange Pilot Plant Study, as well as its Vermilion River Watershed Study and Groundwater Investigation, be deferred and recovered in rates over a 5 year amortization period. (*See* Docket No. 95-0220, Staff Ex. 1.0, pp. 24-26.)

The Commission adopted Mr. Gorniak's proposal. Since the Reverse Osmosis Pilot Study is in the same category, and for the same purpose, as the Ion Exchange Pilot Study, it should be treated in the same manner.

F. Contrary To Ms. Everson's Assertion, The Company Will Not Recover The Same Costs Twice

Ms. Everson erroneously asserted, in her direct testimony (Staff Ex. 4.0, pp. 5-6), that if the Company were allowed to recover this deferred cost, it would be recovering the same costs twice.

Clearly, the same costs will not be recovered twice. In fact, in her rebuttal testimony, Ms. Everson changed her position, stating the "Company would not be recovering the same costs twice." (Staff Ex. 12.0, p. 7.)

In point of fact, the Deferred Reverse Osmosis Pilot Study Costs were incurred in 2001 to test that particular nitrate removal technology. The ongoing costs included in the test year are costs incurred for the different and permanent Ion Exchange removal technology ultimately installed.

It is in the nature of deferred costs that amortization can overlap ongoing costs. Staff witness Sant's recommended deferral treatment of steel structure painting costs is a good example. Another example is the order in *Northern Illinois Water Corporation*, Docket No. 93-0184, where the Commission allowed deferred recovery of the damage to a water treatment plant addition that was almost completed. The amortized amount of the property loss of the plant addition was included in the test year along with the cost of the reconstructed plant addition in rate base and depreciation expense upon the reconstructed plant addition.

Finally, the Illinois Supreme Court's decision in the *Citizens Utilities Board* case allowed recovery of both deferred and on-going coal-tar clean-up costs.